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CURRENT ACCOUNT DEFICITS AND MACROECONOMIC STABILITY: LESSONS FROM AUSTRALIA

Prepared by Lillian Cheung, Alfred Wong, Kelvin Fan and Hong Xiao
Research Department

Abstract

Concerns about the role of external imbalances in the global financial crisis have increased the attention on countries with large current account deficits. However, it is intriguing to see Australia, which has consistently run large current account deficits, to stand out from the crowd with a remarkably resilient economy. A closer look suggests that Australia's current account deficit is the outcome of high private-sector investments rather than low savings. The country has benefited from the commodity boom which boosted the resources sector. It also has effective policies in attracting foreign capital. Besides, enduring economic reforms and faster labour growth due in part to its open-door immigration policy, have all helped sustain long-term economic growth that creates abundant investment opportunities. But more importantly, Australia has been successful in maintaining a strong fiscal position and sound monetary policy framework to prevent the foreign funds from building up excesses and distorting the financial system. In sum, the Australian experience shows us that whether a current account deficit reflects a country's vulnerability depends on its composition and dynamics, and how risks arising from the associated capital inflows are managed.

Authors' E-Mail Addresses:
lcheung@hkma.gov.hk; alfred_yt_wong@hkma.gov.hk; kswfan@hkma.gov.hk; hxiao@hkma.gov.hk

I. Background

Concerns about the role of external imbalances in the global financial crisis have increased the attention on countries that run large current account deficits. However, Australia stands out from these deficit countries in that its economic performance has been remarkably resilient over the past two decades. Australia has been running sizable current account deficits for the past 150 years. Over the past three decades, its current account deficits have averaged 4.3% of GDP, which is significantly higher than the 2.7% in the US and 1.5% in the UK (Chart 1). This has led to a building up of net foreign debt, which is often perceived as unsustainable and being vulnerable to a reversal of sentiments (Chart 2). However, despite the external imbalance, Australia has maintained an uninterrrupted real GDP growth with an average annual rate of 3.4% for 17 years until the outbreak of the global financial crisis in late 2008, and notwithstanding this, still being one of the three OECD member countries registering positive annual GDP growth during the worst of the crisis. The questions are therefore – what explains the persistent current account deficits in Australia, and how have they been sustained without creating any problems to the country's macroeconomic performance? This note attempts to answer these questions, and in doing so, examines whether there are lessons that policymakers could learn from the Australian experience in maintaining macroeconomic stability. It is organised as follows. The next section examines the nature of Australia's current account deficits. Section III investigates the factors that help explain the sustainability of Australia's current account deficits. The last section concludes.

Chart 1: Current account balance

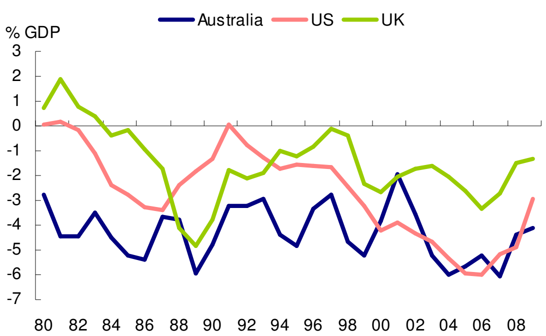
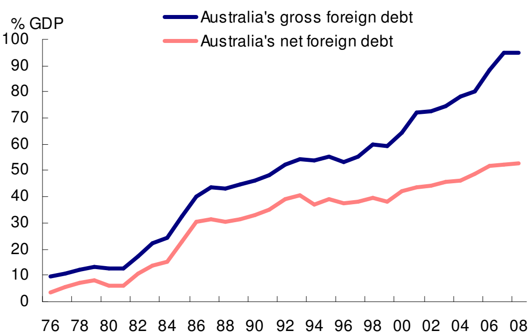


Chart 2: Australia's foreign debt



Sources: IMF's World Economic Outlook, Parliament of Australia.

II. THE NATURE OF AUSTRALIA'S CURRENT ACCOUNT DEFICITS

The persistent current account deficits are mainly attributable to net income outflows, rather than trade deficits. Over the past 30 years, Australia's current account deficits have ranged between 2% and 6% of GDP, but the country's trade balance (of goods and services) has been registering only slight deficits of around 1 - 2% of GDP. Instead, net income outflows accounted for roughly two-thirds of the current account deficits, which were mainly interest and dividend payments on its external liabilities (Chart 3). This probably reflects a high proportion of foreign holdings in the corporate sector, particularly the resources companies. This is in stark contrast to the US current account deficits which have largely been attributable to shortfalls in its trade account (Chart 4).

Chart 3: Australia's current account by main components

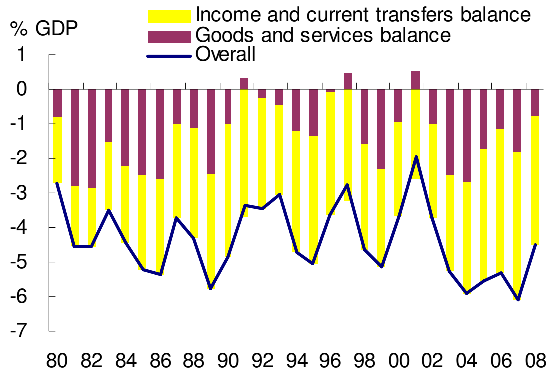
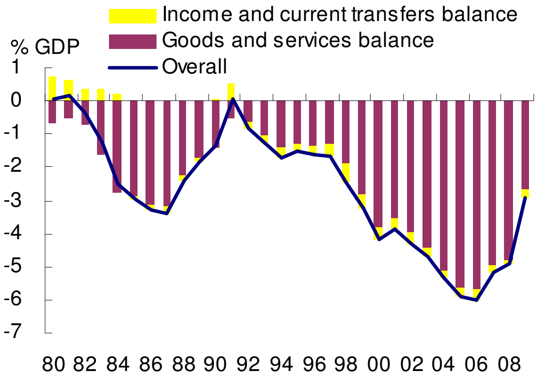


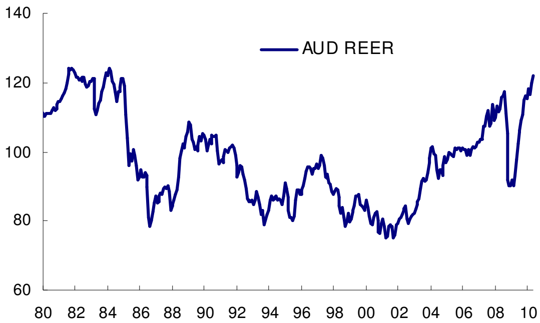
Chart 4: US's current account by main components



Sources: CEIC, IMF's World Economic Outlook and staff calculations.

The trend of Australia's current account deficits has been relatively stable rather than explosive. In fact, the current account deficits have been staying below 6% of GDP in most years over the past three decades. In contrast, the US current account deficits were widening consistently relative to its GDP from the early 1980s until the onset of the recent global financial crisis. In fact, with the real effective exchange rate (REER) of the Australian dollar appearing to be mean-reverting over the past three decades (Chart 5), Australia's current account balance may have been close to its equilibrium level.

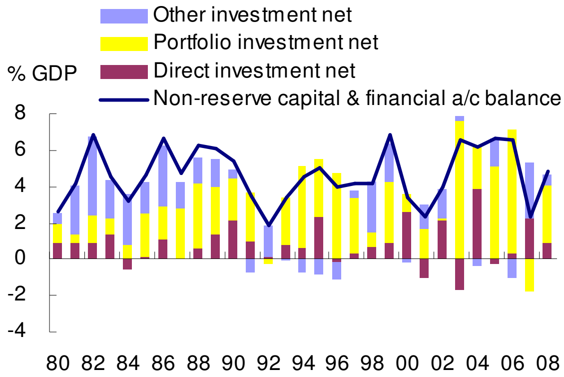
Chart 5: REERs of the Australian dollar and the US dollar



Sources: BIS and staff calculations.

Mirroring the current account deficits, Australia has consistently recorded surpluses in its capital and financial account. A closer look at the balance of payments statistics indicates that net portfolio investment inflows have been the major component, accounting for about half of the total net private-sector capital inflows over the past 30 years, in which an overwhelming majority were foreign investments in private-sector debt securities (Chart 6).

Chart 6: Net private sector capital inflows by main components



Sources: CEIC, IMF's World Economic Outlook and staff calculations.

Reflecting the cumulative size of its foreign assets and liabilities, Australia's net international investment position has also remained fairly stable (Chart 7). This is again in contrast to the US, and even more so to the debt-ridden European countries such as Greece and Spain, where their net international investment positions have been deteriorating. Moreover, the private sector's foreign debt affordability had also improved during the last decade, with net external liabilities falling relative to private-sector financial wealth since the early 1990s (Chart 8).

Chart 7: Net international investment position

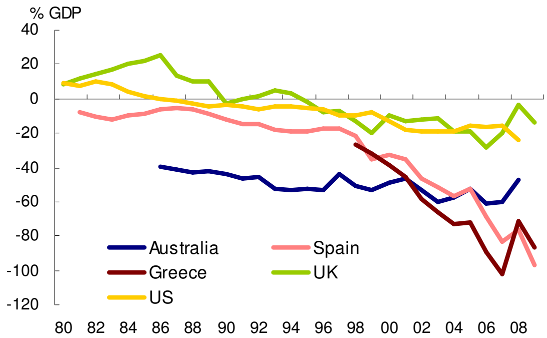
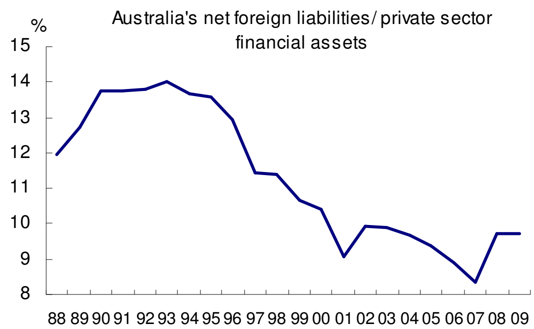


Chart 8: Australia private sector's foreign debt affordability improves



Sources: CEIC, IFS, IMF's World Economic Outlook and staff calculations.

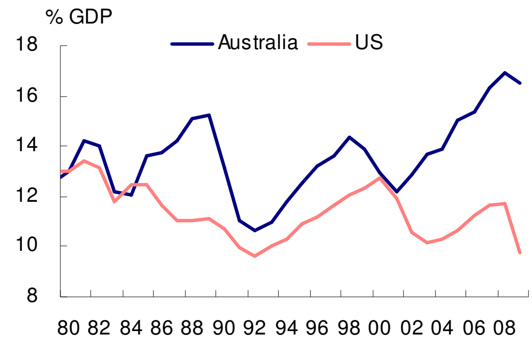
III. WHAT EXPLAINS THE SUSTAINABILITY OF THE CURRENT ACCOUNT DEFICITS?

While the large current account deficit and the building up of foreign debt worried some observers, especially during the 1980s and 1990s, several factors have helped explain the sustainability of the current account deficits in Australia over the past decades.[1]

<u>The deficit reflects the outcome of relatively high productive investment rather than low savings</u>

Although the substantial current account deficit means that the gap between national savings and investment is sizeable, it reflects relatively high investment in Australia rather than low national savings.[2] In fact, Australia's national savings rate has been higher than most major OECD countries except Japan over the past three decades.[3] The gap was actually caused by relatively high investment. Indeed, the share of gross investment in GDP has been higher than other advanced economies (Table 1). Moreover, it is argued that the savings-investment gap and the resulting capital inflows reflect that Australia has more productive investment opportunities than it can fund domestically. While there are no hard data to track which sectors foreign funds were ultimately invested, a relatively high share of non-residential investments in Australia suggests that foreign funds were likely invested in the non-residential sectors (Chart 9). In contrast, it is generally believed that a significant part of capital inflows to the

Chart 9: Non-residential investments of Australia and the US



Sources: CEIC, EMED and staff calculations.

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[1] In fact, there was a heated debate in Australia in the 1980s on whether or not the country had a current account problem or its large deficit needed to be fixed. The debate finally ended with most economists subscribing to a theory that was later widely referred to as the Pitchford thesis. Pitchford in his seminal papers (1989a, 1989b) argues that in Australia the current account deficit is the outcome of rational agents' investment-saving decisions that will maximize households' welfare and firms' profits, while the persistent capital account surplus reflects foreign investors' return-seeking behaviour, given the high return on Australian assets, and therefore the current account deficit could be sustainable and optimal.

[2] In theory, countries with high savings and investment tend to grow faster in a sustainable way.

[3] In recent years, Australia's national savings rate has surpassed Japan's as the Japanese Government has run sizeable fiscal deficits in recent years.

US were used to fund investments in the housing market, which are often regarded as less productive than those in the non-residential sectors.

Table 1: Gross national savings and investments (% of nominal GDP), average for 2000 – 2009

	National Savings	National Investment
Australia	22	27
Canada	23	21
France	20	20
Germany	22	18
Japan	27	23
UK	15	17
US	15	19

Sources: ABS and IMF.

At the same time, the current account deficit is largely driven by private investment with the government sector being a net saver in recent years, though moving moderately into deficit with the recent financial crisis. Foreign debts issued by the private sector account for more than 90% of the gross external liabilities. Indeed, the Australian Government has been running a prudent fiscal policy. The country maintains a long-term fiscal balanced budget and has almost the lowest public debt (less than 20% of GDP in 2009) among OECD countries with only 8% of total foreign debt attributed to the public sector (Charts 10 and 11).

Chart 10: Fiscal balance

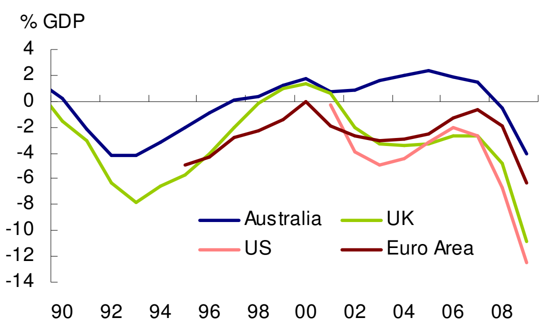
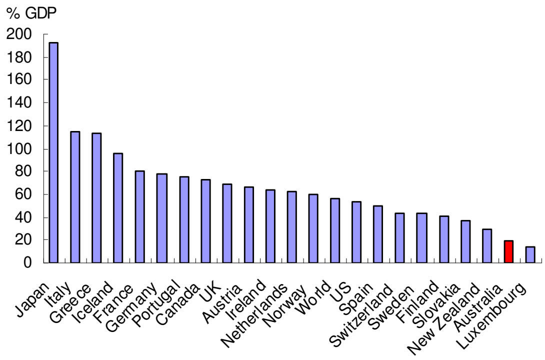


Chart 11: Public debts

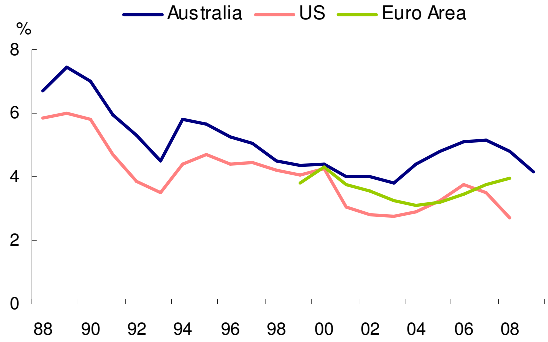


Sources: European Commission's AMECO, CIA and IMF's World Economic Outlook.

<u>Higher investment has been a result of both favourable economic conditions and effective policies</u>

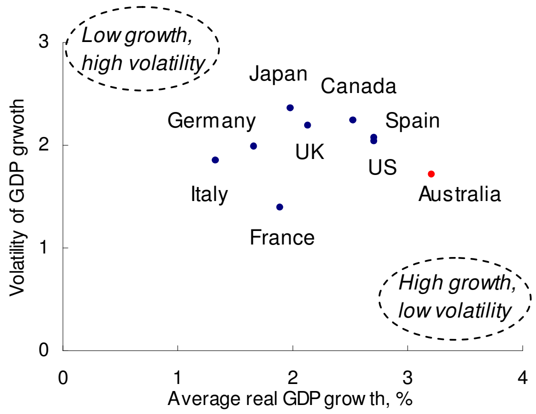
Indeed, the current account deficits might have been driven by capital inflows which were attracted by Australia's abundant investment opportunities, given the country's relatively high and stable economic growth. This is reflected in the higher rate of return on foreign investments in Australia compared with the US and euro area (Chart 12), which may have attracted capital inflows to Australia.[4] The higher return on Australian assets may be explained by the country's higher economic growth, driven by faster rates of capital and labour growth.[5] Not only has Australia's growth been higher relative to other advanced economies, its low growth volatility might also explain why the more risk-adverse investors may have a preference over investing in Australia than in the emerging market economies which tend to generate even higher growth and return. Australia has delivered the highest risk-adjusted macroeconomic return, or the highest Sharpe ratio, over the past three decades (Chart 13). While the country's growth is higher than those in many other OECD economies, its growth volatility is among the lowest, second only to France. The high and stable economic growth also strengthens its capacity to repay external debt.

Chart 12: Returns on foreign investments



Sources: CEIC and staff calculations.

Chart 13: GDP growth Vs volatility (1980 - 2009)



Sources: IMF's World Economic Outlook and staff calculations.

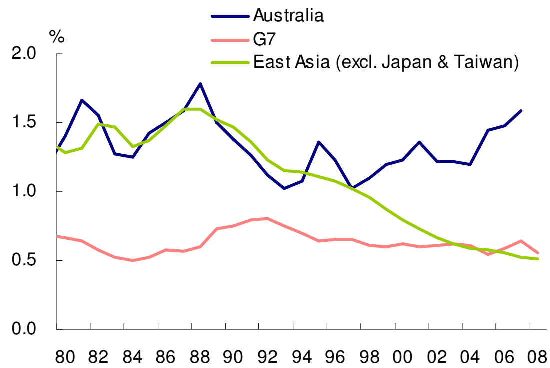
4 The rate of return on foreign investment is measured by income debit under the current account as a percentage of the gross liability of the country's international investment position.

5 See Box F in Reserve Bank of Australia (2009).

Australia's relatively high growth over the past three decades is mainly attributable to faster rates of capital and labour growth.[6] **The faster rate of capital accumulation reflects in part a boom in the capital-intensive resources sector,** which has benefited from strong demand for commodities from the high-growth emerging market economies, such as China and India. Australia's exports have a high concentration on commodities, with nearly 70% being crude materials, fuel, and agricultural products. Higher commodity prices in recent years have led to a boom in Australia's resources sector, and as a result, the country's capital stock has been growing relatively quickly.

Meanwhile, Australia's faster labour growth reflects in part higher population growth than many countries, which is largely due to a substantial increase in immigrants given its "Big Australia" immigration policy. At about 1.4% a year, Australia's population growth is higher than the world average and around twice the G7 average (Chart 14). This, coupled with a rise in the participation rate, has led to a relatively strong growth in the labour force. This may have also led to a higher demand for capital investment if the economy has already reached a high level of capital utilisation.

Chart 14: Population growth



Sources: Australian Bureau of Statistics, The World Bank's World Development Indicators and staff calculations.

Enduring structural economic reforms have also been playing a key role in boosting Australia's trend economic growth and hence its needs for capital accumulation. These reforms significantly boosted productivity particularly in the 1990s to a high level which contributed to stronger economic growth in Australia, though there was evidence of a slowdown in recent years. Australia's productivity, in particular, labour productivity, has been one of the highest among OECD countries. Such a gain in productivity can be attributable to structural economic reforms that brought about deregulation and globalisation. Following the election of a new government in 1983, Australia embarked on a wide-ranging economic reform in the early 1980s, which included liberalisations of the international trade and capital markets, and other structural reforms such as

[6] See Box F in Reserve Bank of Australia (2009).

taxation and competition policy reforms. In essence, the reforms freed up markets, promoted competition, and generally sought to rationalise price setting to ensure that prices were effectively signalling costs and relative returns. These reforms had proven to significantly improve Australia's productivity and hence economic performance in the 1990s.

Sound policy settings have prevented excesses and domestic imbalances

More importantly, by maintaining a favourable policy setting, Australia has been successful in ensuring that the ready availability of foreign funds does not result in the building up excesses and undesirable domestic spillovers:

- **Sound policy framework that takes into account both price stability and financial stability have helped prevent excesses from building up in the domestic economy.** Not only has Australia had a sound and credible monetary policy framework with price stability being the primary objective, financial stability has also been a long-standing responsibility of the Reserve Bank of Australia (RBA). While the RBA transferred its responsibility for the supervision of banks to the Australian Prudential Regulation Authority, the integrated regulator formed in 1998, it has continued with its mandate of maintaining financial stability by focusing on the prevention of financial disturbances with potentially systemic consequences. Reflecting its sound policy settings, both inflation and inflationary expectations have declined sharply since the introduction of the inflation-targeting framework in the 1990,[7] while the economy has experienced a prolonged period of expansion with little evidence of significant internal imbalances.

- **An effective institutional setting has also played an important role in providing an economic environment not only conducive to growth, but also resilient to shocks.**[8] Indeed, the long history of sound institutions have enabled Australia to experience several substantial external shocks without defaulting. The G30 Report on the Structure of

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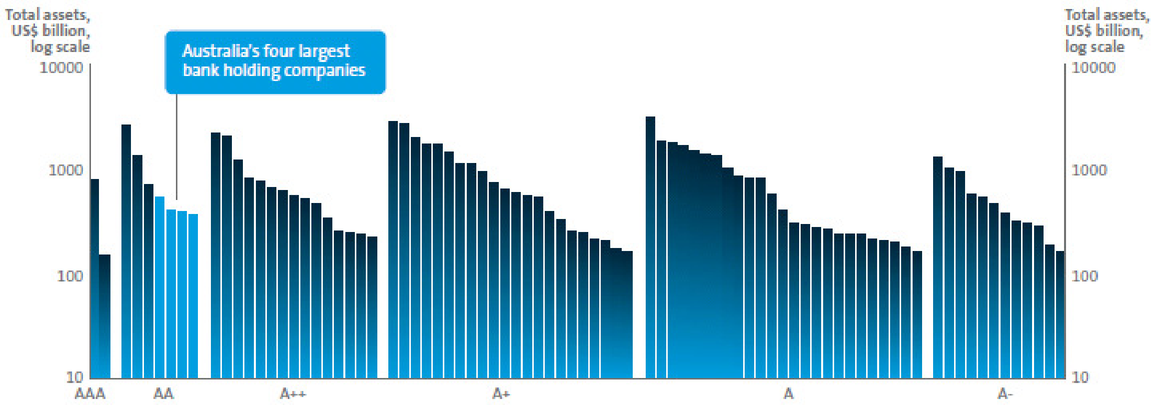
[7] The RBA first indicated an informal objective for inflation in 1993. In August 1996, a clear and transparent Statement on the Conduct of Monetary Policy was agreed between the Treasurer and the RBA Governor. It formalised the target of 'keeping underlying inflation between 2 and 3 %, on average, over the cycle'. Importantly, the Statement formalised a clearer recognition of the independence of the RBA in conducting monetary policy.

[8] The twin-peak model refers to the separation of the regulatory oversight between prudential supervision and consumer protection.

Financial Supervision found that Australia's twin-peak regulatory structure is amongst the most effectively regulated regimes in the world, which ensures transparency, market integrity, and sufficient priority in consumer protection. This has resulted in a very solid and conservative banking system, which plays a key role in intermediating external resources into Australia. Indeed, Australian banks are among the banks with the strongest credit ratings in the world (Chart 15), thus enjoy a comparative advantage in offshore borrowing.

Chart 15: Credit ratings of the 100 largest banking groups in the world

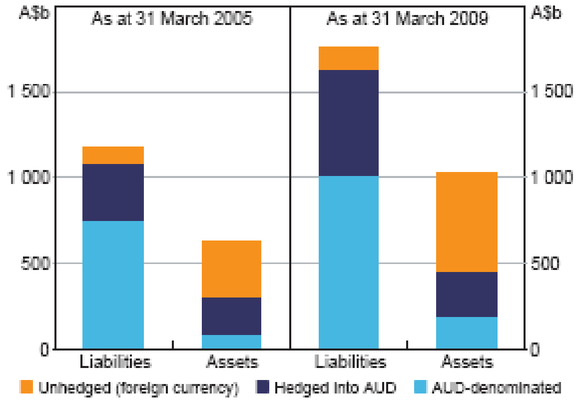


Sources: Standard and Poor's, Bloomberg and *The Banker*.

- **Flexibility of the Australian economy as a result of enduring microeconomic reforms have also helped the economy adjust to external shocks.** As mentioned earlier, Australia has undergone structural reforms since the 1980s, including the areas of competition policy, the labour market, the financial sector and corporate law. These have contributed to a more efficient and flexible economy, subject to more competitive pressures and more conducive to productivity growth. In contrast, in the Argentinian crisis, the Asian financial crisis, or the current European debt crisis, a major problem facing the countries under stress is that they lacked the required economic fundamentals and flexibility to allow adjustment.

Over the past years, Australia's efforts to maintain a stable and well-developed financial system and credible monetary policy have certainly boosted investor confidence. Indeed, effective governance has provided a stable and safe economic and financial environment to uphold the confidence of foreign investors in holding Australian dollar-denominated assets. Australia's foreign liabilities are almost entirely denominated in Australian dollars or hedged to the Australian dollars (Chart 16). With foreign liabilities being largely denominated in local currency, Australian borrowers do not face foreign-exchange risk on these overseas fundings. This reflects the willingness of foreign investors to hold Australian dollar-denominated assets.

Chart 16: Currency composition of Australia's external position



Source: RBA.

IV. CONCLUSION

While there is a general perception that it is riskier for countries to maintain a current account deficit than a surplus, the Australian experience suggests that the outcome depends on the composition and dynamics of the current account balance, and how the risks arising from the associated foreign borrowing or capital inflows are managed. Australia's current account deficit reflects relatively high investments rather than low savings, suggesting that the deficits are less likely to reflect underlying imbalances in the economy. In attracting foreign investments to fund its capital needs, Australia has benefited from the commodity boom which boosted its resources sector and effective policies. Besides, enduring economic reforms and sound immigration policy have helped sustain long-term economic growth that creates abundant investment opportunities. But more importantly, sound policies are needed to ensure that such ready availability of foreign funds does not end up distorting or weakening the financial system. In this regard, the Australian economy has been successful in preventing potential excesses from being realised by maintaining a favourable institutional setting, a strong fiscal position, a robust financial system, and a sound monetary policy framework. Indeed, Australia contrasts with the US where the current account deficit has resulted in a misallocation of credit and building up of excesses which have ended up in a sub-prime crisis.

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